

# State of California

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## Legislative Change No. 99-01

Bill Number: SB 93 Author: Chesbro Chapter Number: 99-8

Laws Affecting Franchise Tax Board: 17507.6

Date Filed with the Secretary of the State: April 12, 1999

SUBJECT: Roth IRA Conformity

**Senate Bill 93 (Chesbro), as enacted on April 12, 1999, made the following changes to California law:**

### **Section 17507.6 of the Personal Income Tax Law**

This Act conformed to the IRS Restructuring and Reform Act of 1998 (IRS Reform Act) technical changes relating to the Roth IRA provisions as follows:

1. Early Withdrawals of Amounts Converted From Regular IRAs to Roth IRAs. Under federal law before the IRS Reform Act, (1) the four-year income spread on Roth IRA conversions was mandatory, not elective, and (2) the 10% early withdrawal penalty tax did not apply to conversions of regular IRAs into Roth IRAs. Thus, under federal law before this change, taxpayers under age 59½ could escape the 10% early withdrawal penalty tax by rolling over funds from a regular IRA to a Roth IRA and then immediately thereafter taking a distribution from the Roth IRA. California had previously recognized this issue and made the California 2½% early withdrawal penalty tax apply in this situation. Now that federal law makes the 10% early withdrawal penalty tax apply, conforming to federal language makes the state 2½% early withdrawal penalty tax continue to apply.

The IRS Reform Act modified the rules relating to conversions of regular IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth Conversion IRA while retaining the benefits of the four-year income spread as follows:

- Acceleration of income inclusion. Where amounts are converted in 1998 and are thus subject to the four-year income spread, income inclusion is accelerated for any amounts withdrawn before 2001, the fourth year of the spread. This is done by adding the amount withdrawn in that year to the amount required to be included in income in that year under the four-year income spread rule. However, a limitation to the inclusion rule is provided to prevent more than the total amount required to be included in income over the four-year period from being included in income.
- Election. The IRS Reform Act provides an election to include entire converted amounts in income in a single year. Once made, the election cannot be changed.

Bureau Director

Date

- Application of early withdrawal tax to converted amounts. If converted amounts are withdrawn within the five-year period beginning with the year of the conversion, the amount withdrawn, only to the extent attributable to amounts that were includible in income due to the conversion, will be subject to the 10% early withdrawal tax.

Under state law, prior to the passage of this Act, as under federal law before the passage of the IRS Reform Act, the four-year income spread on Roth IRA conversions was mandatory. However, under state law, if a taxpayer received an unqualified distribution during the first five years after the conversion, any unrecognized income due to the four year spread would be accelerated into income for the year the unqualified distribution was made. Additionally, the 2½% early withdrawal penalty tax would apply to the entire converted amount (not just the unqualified distribution amount.) A qualified distribution only included a distribution to: an individual 59½ or older; a beneficiary or the estate of a deceased individual; a disabled individual or a distribution which qualified as a special purpose distribution.

This Act repealed California's treatment of distributions from regular to Roth IRA rollovers and conformed to the new federal treatment. This Act requires that any election made for federal purposes regarding the income spread also apply for California purposes.

2. Determination of Five-Year Holding Period. Under the law before the IRS Reform Act change, the five-year holding period with respect to conversion of Roth IRAs began with the tax year of the conversion.

- Applying the five-year holding period for Roth IRAs. The IRS Reform Act eliminated the special rule under which a separate five-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution. Thus, the five-year holding period rule for Roth IRAs will begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion will not start the running of a new five-year period.
- Return of excess contributions. Distributions of excess contributions and earnings allocable to the contributions are not considered qualified distributions.
- Ordering rules. Ordering rules are provided to determine which amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions will be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted).

Withdrawals of converted amounts will be treated as coming first from converted amounts that were includible in income. Earnings will continue to be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs (regardless of whether maintained in separate accounts) are considered a single Roth IRA.

3. Corrections of Erroneous Conversions. Under the law before the IRS Reform Act change, no mechanism allowed a taxpayer to correct (undo) or recharacterize an erroneous conversion, such as when a taxpayer makes a conversion early in a tax

year and then discovers by the end of the year that the AGI limit of \$100,000 has been exceeded and, thus, the taxpayer is ineligible to make the conversion.

The IRS Reform Act provides that contributions to an IRA and earnings on those contributions may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer's return for the year of the contribution (including extensions). Any transferred contributions will be treated as if contributed to the transferee IRA and not to the transferor IRA. Any transfer of contributions must be accompanied by any net income allocable to the contributions. Also, these transfers are permitted only if no deduction was allowed with respect to the contribution to the transferor plan. These provisions are effective for tax years beginning after December 31, 1997.

In 1998, Franchise Tax Board issued two legal rulings regarding Roth IRAs:

- Legal Ruling 98-3 provides rules regarding the taxation of IRA distributions rolled over to a Roth IRA in 1998 followed by a change in residence status.
- Legal Ruling 98-4 provides that for the 1998 taxable year, a taxpayer who makes a trustee-to-trustee transfer from a federally designated Roth IRA that recharacterizes contributions to the Roth IRA for federal purposes, such transfer shall be treated as designating the Roth IRA as a traditional IRA for California tax purposes. As a result, taxpayers that recharacterize a contribution to a Roth IRA will be treated the same for California purposes. By adopting the federal recharacteration rules, this Act makes Legal Ruling 98-4 redundant.

4. Effect of Account Holder's Death during Four-Year Spread Period. The IRS Reform Act provides that if a taxpayer made a 1998 rollover to a Roth IRA and dies at any time during the four year spread period, the entire amount not previously included in taxable income is taxable on the return for the year of the decedent taxpayer's death. Thus, if a taxpayer died in 1998, all of the income from a 1998 rollover is taxable on the decedent's 1998 tax return.

The IRS Reform Act allows surviving spouse beneficiaries to elect to defer the income received from a regular IRA converted to a Roth rollover in 1998 on account of the decedent spouse. For taxpayers dying in 1998, a surviving spouse may elect to spread the income over four years. For taxpayers dying after 1998, a surviving spouse may elect to spread (up to three years) any remaining deferred taxable income that resulted from a 1998 conversion.

5. Determination of AGI Limit for Conversions. The IRS Reform Act provides that AGI, for purposes of applying the \$100,000 threshold, is determined in the same manner as for regular IRAs. For regular IRAs, AGI includes taxable social security and railroad retirement benefits and the application of the passive activity loss rules. However, the exclusions for interest on U.S. savings bonds used to pay higher education expenses, for employer-provided adoption assistance programs, and for foreign earned income are not taken into account in determining AGI. In addition, the deduction for a contribution to a regular IRA is not taken into account.

The IRS Reform Act also makes it clear that the applicable AGI is the AGI for the year of the distribution to which the conversion relates. It also clarifies that, for purposes of computing taxable income, the conversion amount is to be taken into

account in computing all AGI-based phase-out amounts except for the modified AGI amount used in Roth IRA conversions.

6. Clarification of Phase-out Range. The \$2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with AGI between \$95,000 and \$110,000 and for married taxpayers filing a joint return with AGI between \$150,000 and \$160,000.

The IRS Reform Act clarifies that the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return is \$0 to \$10,000 of AGI.

7. Clarification of Contribution Limit. The IRS Reform Act clarifies that the maximum amount of contributions an individual may make to all of his or her IRAs is limited to a cumulative total of \$2,000 per year.

The IRS Reform Act also provides that a simplified employee pension (SEP) or a SIMPLE IRA may not be designated as a Roth IRA and contributions to a SEP or SIMPLE IRA cannot be taken into account for purposes of the \$2,000 contribution limit. Thus, contributions to a SEP or SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA.

All provisions contained in the IRS Reform Act that affect Roth IRAs have an operative date for federal law for tax years beginning after December 31, 1997.

This act is effective January 1, 1999, and is operative January 1, 1998.

This act will not require any reports by the department to the Legislature.

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